

Issuance Of Subsidiary Stock As An Earnings Management Strategy

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ABSTRACT

Arthur Levitt, chairman of the Securities and Exchange Commission, expressed concern that the pervasiveness of earnings management in American corporate financial statements threatens the integrity of financial reporting. Levitt referred to the “cookie jar” phenomenon wherein U.S. firms have earmarked opportunities to “find gains” when earnings are less than anticipated. The academic research literature includes a large number of studies on earnings management strategies. One relatively unexplored strategy is the use of stock issuances by subsidiaries to generate gains under the provisions of SEC Staff Accounting Bulletin No. 51. Based upon a sample of 125 observations of this accounting choice over the period 1985 through 1997, our study provides compelling evidence that recognition of gains on the issuance of subsidiary stock coincides with periods when earnings fail to meet expectations (as measured by analysts’ forecasts), and that the recognition of these gains in the income statement is effective in achieving earnings expectations. Further, the amounts of these gains are large relative to pre-gain net income

INTRODUCTION

*F*inancial statements are intended to reflect the underlying economic condition of the firm. If managers have incentives and opportunities to manage earnings, concerns arise about the quality of earnings and the integrity of financial reporting. Arthur Levitt, former chairman of the Securities and Exchange Commission, expressed concern that earnings management has become pervasive in American corporate financial statements. Levitt referred to the “cookie jar” phenomenon wherein U.S. firms have set aside funds or earmarked opportunities to “find gains” when earnings are less than anticipated. This type of earnings management threatens the credibility of financial reporting.

Managers seeking to offset sizeable declines in accounting earnings can choose from a variety of sources. In general, three common techniques are used to manage earnings. First, GAAP permits some flexibility in choices of accounting methods, and managers may change methods to augment poor reported earnings. Indeed, there are often variations in the degree of change that can be made, which allows a manager to tailor the changes to the earnings improvement needed. For example, Keating and Zimmerman (2000) report that companies making income-increasing changes in depreciation methods *for all assets* had significantly lower financial performance than companies making income-increasing changes in depreciation methods *for new assets only*. Second, financial reporting under accrual accounting requires a large number of subjective estimates. The flexibility inherent in the estimates allows managers to manage earnings by smoothing or shifting costs or revenues from one period to another. Accounting accruals have been examined in a number of settings and have been found to be a popular form of earnings management since investors cannot easily infer the discretionary component of the total accrual. (Healy, 1985; DeAngelo, 1986; Liberty and Zimmerman, 1986; McNichols and Wilson 1988; Jones, 1991; Cahan, 1992; Perry and Williams, 1994; and DeChow, 1994.) While a substantial portion of the accrual is non-discretionary, managers have the ability to make accounting choices that are beyond those determined by firm and industry conditions. Third, firms can manage earnings through modifications in the timing and/or amounts of planned acquisitions and dispositions of assets. Bartov (1993) finds evidence that firms time asset sales in order to smooth income and that firms are more likely to sell assets for a gain as their debt to equity ratio increases. Similarly,

financial companies have large portfolios of investments that still provide easy sources of income (or loss) when needed, even though GAAP has been tightened somewhat in recent years. And firms can adjust the amount of discretionary expenditures (e.g., R&D and advertising) they make in order to manage current earnings up or down. These earnings management choices represent real economic transactions that because of their accounting treatment present earnings management opportunities through their timing.

In this paper, we explore the issuance of subsidiary stock as an earnings management strategy. This strategy is another, more subtle version of the assets sales category. Presumably the parent firm can influence the timing on the sale of subsidiary stock, which provides capital to the subsidiary. At the same time, the parent can elect to account for the transaction as either a capital transaction or an income increasing (or decreasing) transaction. This paper provides systematic evidence that gains on the issuance of subsidiary stock coincide with periods when earnings would otherwise fail to meet analysts' expectations. These findings add to the body of empirical evidence supporting the SEC's concerns about the prevalence of earnings management.

ACCOUNTING FOR SUBSIDIARY STOCK ISSUES

Accounting for sales and purchases of an entity's own common stock as a capital transaction is a principle that has been accepted in the United States for at least as long as formal standards have been issued by accounting standard setters. By extension, changes in a parent company's equity in the net assets of a subsidiary due to stock issuances or repurchases *by the subsidiary* also were treated as a capital transaction. But as some professionals and academics recognized, issuance of stock by a subsidiary is, from the point of view of the parent company, not the same as issuing its own stock. To the contrary, it is argued that the subsidiary stock issuance is similar (perhaps in substance economically equivalent) to a sale *by the parent* of a portion of its interest (investment) in the subsidiary. This perspective on the transaction leads naturally to the conclusion that the parent company should recognize *income* in the consolidated financial statements when one of its subsidiaries issues its shares to third parties.¹ Until 1983, the capital transaction view remained the only authoritative treatment in the consolidated financial statements for reporting the effects of an issuance of stock by a subsidiary. Building upon an AICPA *Issues Paper* that was published in 1980,² the Securities and Exchange Commission in 1983 released Staff Accounting Bulletin No. 51 (SAB 51), which permitted registrants to choose either the income or the capital perspectives in their filings with the Commission.³

To illustrate the financial effects of a subsidiary stock issuance, consider the following scenario. Assume that an 80%-owned subsidiary with 1,000 shares of common stock outstanding has net assets (shareholders' equity) of \$250,000 on January 1, 2001. On this date, the subsidiary issues an additional 200 shares of its stock to third parties for \$68,000. As a consequence of this transaction, the parent company's percentage ownership interest in the subsidiary drops from 80% (800/1000 shares) prior to the sale of shares to 66.7% (800/1200) after the sale of shares. At the same time, the increase of \$68,000 in the net assets of the subsidiary results in the parent's equity in these net assets increasing from \$200,000 (80% of \$250,000) to \$212,000 (66.7% of \$318,000.) Under the capital transaction interpretation, the \$12,000 gain in value would be reported as an addition to consolidated paid-in capital. However, when the reduction in ownership interest is treated as equivalent to a sale by the parent company of a portion (13.3%) of its investment in the subsidiary, the \$12,000 gain is reported in Income from Continuing Operations in the consolidated income statement. [A more comprehensive analysis of the equivalence aspects of this type of transaction is provided in the Appendix].

¹ This conclusion is based upon the still accepted view that the sale of a portion of a parent company's investment in a subsidiary is an income generating transaction. In 1999, the FASB indicated that it would consider resuming discussion on consolidation procedures after the completion of current efforts on consolidation policy. If the entity perspective view were to prevail in these discussions, the case for income treatment of the subsidiary stock issuance would be limited.

² Accounting Standards Division, "Accounting in Consolidation for Issuances of a Subsidiary's Stock," *Issues Paper* (New York: AICPA, 1980)

³ Securities and Exchange Commission, "Accounting for the Sales of Stock by Subsidiary Company," *Staff Accounting Bulletin No. 51* (Washington: SEC, March 29, 1983)

USING SUBSIDIARY STOCK ISSUANCES TO MANAGE EARNINGS

In the first academic study of how companies were responding to the issuance of SAB 51, Davis and Largay (1988) examined 34 incidences involving 20 companies of gains/losses on the issuance of subsidiary stock reported in financial statements mainly from 1983-1985. They observed that 33 of the events produced gains and that most (30) of the gains were reported in income. In half of the cases, deferred taxes were not provided on the gains. Additionally, the gains were large relative to net operating income and net income, with conservative estimates averaging 27.6% and 57.5% respectively. Davis and Largay also expressed concerns about the quality of the financial reporting and the potential window dressing related to the reporting of material gains without disclosing the potentially unfavorable tax effects.

Hand and Skantz (1998) examined gains/losses on the issuance of subsidiary stock in those cases in which a wholly or partially owned subsidiary makes an initial public offering (IPO) of common stock. They identified 100 of these types of transactions, which they label “equity carve-outs,” from 1983 to 1993. In their sample, equity carve-out gains/losses were reported in the income statement for 81 firm observations, and in 53% of these cases, the companies provided for deferred taxes. They also found that the carve-out gains/losses before taxes averaged (in 1993 dollars) \$61 million, or 59% (median) of pre-gain net income in the carve-out year. As with the Davis and Largay results, the gains on these transactions continue to represent very material amounts for the companies reporting them.

Hand and Skantz analyzed the economic determinants of the carve-outs from three perspectives, drawing upon three theories of accounting choice: efficient contracting, earnings management, and information signaling. For each perspective, they examine two choice sets: (1) recognizing the gain/loss as income or as capital, and (2) for those gains/losses reported as income, whether or not deferred taxes were provided. In the efficient contracting perspective, they made univariate comparisons of hypothesized economic determinants (the set of proxies include parent size, size of gain, leverage, unexpected discretionary write-offs, unexpected parent operating income before the gain, unexpected future operating income, and annual operating income) across the two choice sets. Because the univariate tests of hypotheses may not be mutually exclusive, the authors also incorporated all of the proxies into two binomial logistic models, one for each choice set. In their analysis of the 100 carve-outs from the perspective of the earnings management theory of choice, Hand and Skantz (like Davis & Largay) observed that the gains on these transactions are relatively large (median of 59% of pre-gain income). In part because of this size, Hand & Skantz predict that the carve-out gains may be used to offset large and transitory discretionary write-offs and write-downs. They find that gains on equity carve-outs reported in the income statement tend to occur in periods when the firm takes discretionary charges related to restructuring write-offs, goodwill write-downs, and other one-time charges. They suggest that parents either time write-offs to coincide with their undertaking an equity carve-out that is recognized in the income statement, or vice versa. They were unable to determine whether the gain provided the opportunity to take write-offs, or whether the write-offs precipitated the gain recognition on equity carve-outs to mitigate the impact of write-offs on net income. Overall, Hand and Skantz (p. 199) conclude, “parents make SAB 51 choices for diverse but economically well founded reasons, most particularly to reduce the cost of financial distress caused by high leverage [an efficient contracting argument] and to mitigate the effect of large discretionary write-offs [an earnings management argument].”

Prior research has linked earnings management to theories that explain the incentive to adopt income-increasing accounting changes. DeGeorge, Patel, and Zeckhauser (1999) suggest that monitoring by investors, directors, customers, and suppliers creates incentives for self-interested managers to (1) report positive profits, (2) sustain recent performance, and (3) meet analysts’ forecasts. They do not examine the means by which earnings are manipulated. However, they propose a model and suggest strategies to manage earnings. Burkstahler and Dichev (1997) find an unusually high frequency of zero and small positive earnings surprises relative to small negative surprises in their sample distribution of earnings surprises. They conclude that both earnings and analyst forecasts are managed.

This research suggests that another way to view the accounting and economic choices relating to the issuance of subsidiary stock is their potential role in enabling the firm to meet analysts’ forecasts. By taking this

alternative (and complementary) perspective, discretionary write-offs are only one of the possible reasons for a firm's failure to meet analysts' expectations, and thus only one of the reasons for the economic and/or accounting choice on the subsidiary stock issuance. Our analysis therefore augments the evidence provided by Hand and Skantz. The relationship we find between negative earnings surprises and the gain on the issuance of subsidiary stock may be due to discretionary write-offs that occurred (or are elected) in the period. Or, it may be due to a shortfall in meeting expectations for any number of other reasons. We also find that the relationship is not limited to initial carve-outs but is observed with subsequent issuance of subsidiary stock.

SAMPLE CHARACTERISTICS

To identify the sample, we searched the Lexis/Nexis database using a key word search on "gain (or loss) on the issuance of subsidiary stock". The search resulted in 192 observations between 1985 and 1997. We then examined the financial statements for these firms in their 10-K filings with the Securities and Exchange Commission (SEC) to determine the accounting treatment of the transaction. For each transaction, we also required Compustat data and financial analyst forecasts from I/B/E/S for the parent company. Our final sample included 54 firms and 125 firm year observations over the 1985-1997 time period. 23 (43%) of the firms appear in the sample only once, but 13 firms have two observations, nine firms have three observations, six firms have four observations, one firm has five observations, one firm has seven observations, and one firm has 13 observations. As a control for earnings surprises absent a gain on the issuance of subsidiary stock, we included data for three years before and three years after the year of issuance of subsidiary stock for each firm in our sample.

Our focus is on the relation between the reported gain on the issuance of subsidiary stock and the firm's ability to meet analysts' forecasts for annual earnings. We define post-gain earnings surprise as the difference between reported annual earnings per share and the analyst consensus forecast from I/B/E/S database, and the pre-gain annual earnings surprise as the difference between pre-gain earnings per share and the analyst consensus forecast. We use income from continuing operations, which includes the gain, because it is a focal point for the analysts and investors. We also deflate the earnings surprises by the reported EPS from continuing operations to provide information on the relative importance of the gains. In summary,

Post-Gain Earnings Surprise =
$$\frac{[\text{Reported Income from Continuing Operations} - \text{Analysts' Mean Consensus Forecast}]}{\text{Reported Income from Continuing Operations}}$$

Pre-Gain Earnings Surprise =
$$\frac{[\text{Reported Income from Continuing Operations} - \text{Gain (Loss) adjusted for any tax allocation} - \text{Analysts' Mean Consensus Forecast}]}{\text{Reported Income from Continuing Operations}}$$

Where

Reported Income from Continuing Operations = Actual EPS from continuing operations as reported by I/B/E/S

Analysts' Mean Consensus Forecast = I/B/E/S mean consensus forecast

Gain = Gain on Issuance of Subsidiary stock as reported in Income Statement (from 10-K)/shares outstanding from I/B/E/S

Tax = Deferred tax on Gain as reported in 10-K

Earnings per share and analysts' forecasts as reported in the I/B/E/S database do not include unusual and nonrecurring charges so the variable excludes extraordinary items. Thus, any evidence of earnings management excludes management choices to affect earnings through extraordinary reporting item strategies. To ensure that the gain has not been incorporated into the analysts' forecasts, we use beginning of the year analysts' forecast, forecast prior to the gain recognition (when it could be determined) and 4th quarter annual forecasts. We report results based

on annual forecasts made in the 4th quarter, but our findings are robust to each variation which suggests the gain has not been captured in the forecast.

Table 1 Descriptive Statistics for Firms Reporting Gains on the Issuance of Subsidiary Stock In Year of Gain					
Variable N=125	Mean	Std Dev.	Q1	Median	Q3
Total Assets (\$M)	8450.996	21758.58	390.90	1201.96	4710.70
Sales (\$M)	3631.329	5787.72	215.18	1204.80	3376.03
Debt/equity	2.053	12.12	0.25	0.65	1.24
Reported Net Income (\$M)	259.409	668.70	8.45	29.52	162.20
Net Income Pre-Gain (\$M)	222.606	637.07	2.26	17.56	115.74
Book Value of Equity (\$M)	1503.243	2365.44	113.66	341.99	1754.36
Market Value of Equity (\$M)	6739.137	21476.67	267.54	1204.46	4451.79
Gain (\$M)	47.054	86.01	4.48	12.00	46.40
Gain (\$M, net of tax)	36.563	62.92	2.96	10.50	40.60
Gain/Share (net of tax)	0.361	0.71	.05	0.17	0.36
Earnings Surprise/Share Pre-Gain (\$)	-0.410	0.84	-0.42	-0.19	-0.07
Earnings Surprise/Share Post-Gain (\$)	-0.049	0.39	-.05	0.00	0.02
Earnings Surprise Pre-Gain (%)	-48.067	62.01	-58.88	-28.42	-6.27
Earning Surprise Post-Gain (%)	-9.830	51.19	-6.89	0.00	02.7
Earnings per Share Post-Gain (\$)	1.039	1.61	0.30	0.64	1.24
Earnings per Share Pre-Gain (\$)	0.678	1.70	0.09	0.46	1.03

(\$M) = millions of dollars

Earnings Surprise/Share Pre-Gain (\$): ((Actual EPS-Gain (net of tax))- Analyst Forecasted EPS)

Earnings Surprise/Share Post-Gain (\$): (Actual EPS)- Analyst Forecasted EPS)

Earnings Surprise Pre-Gain (%): ((Actual EPS -Gain (net of tax))- Analyst Forecasted EPS)/Actual EPS

Earning Surprise Post-Gain (%): (Actual EPS- Analyst Forecast)/Actual EPS.

Earnings per Share Pre-Gain (\$): Actual EPS – Gain (net of tax).

Earnings per Share Post-Gain (\$): Actual EPS.

EPS as reported by I/B/E/S

Descriptive statistics for the sample are provided in Table 1. In the year of the reported gain on issuance of subsidiary stock, mean (median) total assets (in millions) for the sample is \$8.451 billion (\$1.202 billion). Mean (median) sales are \$3.631 billion (\$1.205 billion) and mean (median) market value of equity is \$6.739 billion (\$1.204 billion). This suggests that some fairly sizeable firms are present in our sample. Based on our analysis of mean return on assets, mean return on sales, and mean debt to equity ratios, it does not appear that our sample is comprised of unusual firms.

Reported mean net income is \$259.4 million and would have been \$222.6 million in the absence of the gain on issuance of stock by a subsidiary after adjusting for income tax. Therefore, the mean gain of \$47.0 million (\$36.6 million after-tax) represents a substantial impact on the reported earnings of the firm and suggests that the ability to create gains through the issuance of subsidiary stock provides the parent firms with a sizeable “cookie jar” option.

ANALYSIS OF RESULTS

Because of the market focus on analysts’ earnings per share forecasts, we calculate the *post-gain earnings surprise* as the difference between reported earnings per share and the analyst consensus forecast (both from I/B/E/S database) and the *pre-gain earnings surprise* as the difference between pre-gain earnings per share (reported earnings per share less gain adjusted for tax allocation) and the analyst consensus forecast. We reduce the gain by tax effects to avoid overstating our results and to more clearly reflect the impact on reported earnings. Not all firms

provided for income taxes on the gain. In some cases, the gain disclosure reported tax effects, in other cases, the disclosure noted that this would be treated as a non-taxable gain, and in some cases, no mention was made of tax effects. Additional instances of income tax recognition were gathered from the tax note in the firm's 10-K filing.

The mean (median) pre-gain earnings surprise is -48.0 (-28.4) percent of actual earnings per share as compared to the mean (median) earnings surprise after reporting the gain of -9.8 (0.00) percent of actual earnings per share⁴. Although the mean earnings surprise is negative, the median post-gain earnings surprise is zero suggesting that after reporting the gain, the firm was successful in meeting analysts' expectations. Reported (post-gain) mean earnings per share for the firms in our sample was \$1.039 and would have been \$0.678 in the absence of the reported gain on issuance of subsidiary stock (pre-gain). Thus, by reporting the gain on the issuance of subsidiary stock the firms avoided a mean earnings surprise of -\$0.361 per share. Further, this -\$0.361 per share represents an increase of 53.2% over pre-gain earnings per share. Considering that even a very small earnings surprise can create market shocks to the stock price, the ability to book a gain on the issuance of subsidiary stock of this magnitude is quite noteworthy.

Table 2
Comparison of Levels and Signs of Earnings Surprise for Gain and Non-Gain Years

Panel A: Comparison of Levels of Earnings Surprise for Gain and Non-Gain Years				Panel B: Comparison of Signs of Earnings Surprise for Gain and Non-Gain Years	
	Mean (Median) \$ EPS Surprise	Mean (Median) % EPS Surprise	Mean (Median) \$ EPS	Positive/Negative Mean (Median) EPS Surprise	
Pre-Gain	0.410 ^a (-0.196) ^b	-48.0% ^a (-28.4%) ^b	0.678 ^a (0.467) ^b	Positive ^c 14	Negative ^c 111
				0.184 (0.027)	-0.485 (-0.228)
Post-Gain	-0.049 (0.00)	9.80% (0.00%)	1.039 (0.640)	Positive 66	Negative 59
				0.098 (0.020)	-0.214 (-0.07)
Non-Gain	-0.053 (0.000)	-13.4% (0.00%)	0.916 (0.605)	Positive 179	Negative 156
				0.122 (0.030)	-0.256 (-0.050)

Earnings Surprise/Share Pre-Gain (\$): ((Actual EPS-Gain (net of tax))- Analyst Forecasted EPS)

Earnings Surprise/Share Post-Gain (\$): (Actual EPS)- Analyst Forecasted EPS)

Earnings Surprise Pre-Gain (%): ((Actual EPS -Gain (net of tax))- Analyst Forecasted EPS)/Actual EPS

Earnings Surprise Post-Gain (%): (Actual EPS- Analyst Forecast)/Actual EPS.

Earnings per Share Pre-Gain (\$): Actual EPS – Gain (net of tax).

Earnings per Share Post-Gain (\$): Actual EPS.

EPS as reported by I/B/E/S

^a T-test for difference in means: Mean Pre-gain earnings surprise, earnings surprise % and earnings per share are significantly different from mean post-gain earnings surprise, earnings surprise % and earnings per share and from non-gain year mean earnings surprise, earnings surprise % and earnings per share at < .01 level of significance.

^b Wilcoxon test for difference in median scores: Mean Pre-gain earnings surprise, earnings surprise % and earnings per share are significantly different from mean post-gain earnings surprise, earnings surprise % and earnings per share and from non-gain year mean earnings surprise, earnings surprise % and earnings per share at < .05 level of significance.

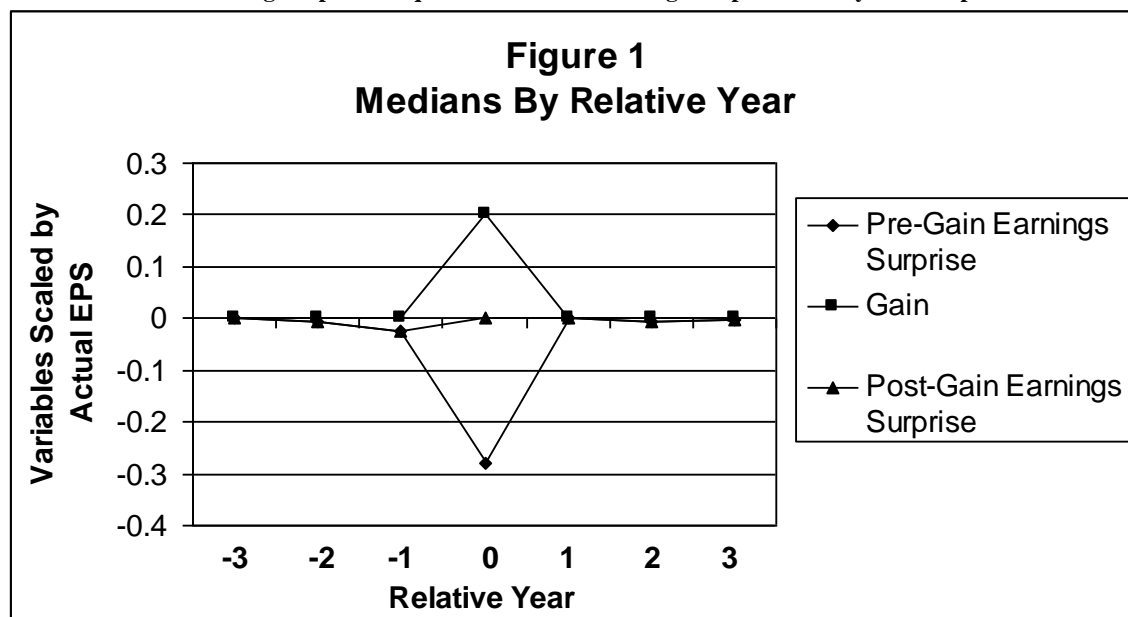
^c Chi-Square test for distribution frequency of positive/negative earnings surprise measure. Pre-gain frequency distribution is different from post-gain and non-gain firms at the <.01 significance

⁴ Pre-gain and post-gain earnings surprises were scaled by actual earnings per share. To avoid outlier problems, we winsorized the variables at +/- 200%.

In Table 2, we present a comparison of magnitudes and signs of pre-gain and post-gain year earnings and earnings surprises. In addition, to control for typical firm behavior, we include an analysis of the same variables for the three years before and three years after the gain year. We find that recognizing this gain allows the firm to be more representative of their typical behavior in non-gain years. That is, the firms that recognize this discretionary gain are not firms that always fail to meet analysts' expectations. Rather, over the seven-year period, it is only the gain year that requires a substantial boost to earnings to meet analysts' expectations-- a boost that was provided in that year by recognizing the gain on the issuance of subsidiary stock.

In Panel A, pre-gain median earnings per share (\$.467) and median earnings surprise (\$-0.196) are statistically different from non-gain year earnings per share (\$0.605) and earnings surprise (\$0.000) at $< .05$ significance level based on a Wilcoxon test for differences in median scores. Post-gain and non-gain earnings per share (median \$0.640 vs. \$0.605) and the post gain and non-gain earnings surprise as a percent of actual earnings per share (median 0.0% vs. 0.0%) are not statistically different at the .10 level significance level. This suggests that by reporting the gain on the issuance of subsidiary stock, the firm is able to achieve its typical reporting scenario.

Pre-Gain Earning Surprise is equal to Post-Gain Earnings Surprise for all years except Year 0.



In Figure 1, we plot the pre-gain earnings surprise, the gain per share, and the post-gain earnings surprise for the year of the gain and the three-year period before and after the gain year. The gain year is defined as year 0. For all 7 years (year -3 to year 3) the median post-earnings surprise is very near zero (consistent with prior research on the distribution of earnings surprises). The graph reflects the ability of the gain in Year 0 to offset the pre-gain earnings surprise and thus continue the trend of no post-gain earnings surprises.

In Table 2, Panel B, we analyze our earnings surprises based on their sign. One of the most striking contrasts in our sample is the distribution of companies in our two by two classification table. Pre-gain earnings surprise is negative for 111 firms (88.8%) and positive for only 14 firms. However, after recognizing the gain on the issuance of subsidiary stock, only 59 (47.2%) report negative earnings surprises and 66 have positive earnings surprises. The distribution of post-gain earnings surprise is consistent with the firms' pattern in the non-gain years. For the non-gain years, we observe that 46.6% (156) of the earnings surprises are negative. This distribution frequency is significantly different from the distribution frequency of the pre-gain earnings surprise at $< .01$ significance level. However, the non-gain year negative distribution frequency and the post-gain negative

distribution frequencies (46.6% vs. 47.2%) are not statistically different at the .10 significance level. This suggests that the post-gain earnings surprise is representative of the firms' typical reporting patterns.

For 14 firms with positive pre-gain earnings surprises, the mean earnings per share changed by \$0.09 (median \$0.11), or 8% of pre-gain earnings per share due to the reported gain. On the other hand, for the 111 firms with negative earnings surprises, pre-gain earnings per share increased by \$0.40 (median \$0.22), or 64% of pre-gain earnings per share. This finding is consistent with a scenario in which it is much more important for firms to find earnings when they miss the analysts' expectations.

Table 3
Rank of Pre-Gain Earnings Surprise and Gains on the Issuance of Subsidiary Stock

Decile	Mean		Median	
	Pre-Gain Earnings Surprise	Gain per Share	Pre-Gain Earnings Surprise	Gain per Share
1	-2.330	1.709	-1.680	1.296
2	-0.715	0.716	-0.688	0.684
3	-0.452	0.333	-0.435	0.370
4	-0.288	0.266	-0.284	0.261
5	-0.223	0.172	-0.227	0.213
6	-0.172	0.147	-0.174	0.156
7	-0.109	0.114	-0.102	0.102
8	0.069	0.058	-0.068	0.051
9	0.014	0.061	-0.010	0.024
10	0.215	0.070	0.045	0.026

Pre-Gain Earnings Surprise/Share (\$): ((Actual EPS-Gain (net of tax))- Analyst Forecasted EPS) Gain Per Share = (Gain [from Annual 10-K] – Tax Allocation [from Annual 10-K]/Actual Earnings Per Share from IBES)

In order to examine the correspondence of the earnings surprises and the gains recognized across the distribution of observations, we rank our sample based on pre-gain earnings surprise. Our findings, reported in Table 3, suggest that the magnitudes of the gains are closely related to the distribution of earnings surprises. Consistent with our conjecture that gains on the issuance of subsidiary stock are used to mitigate earnings shortfalls, mean (median) pre-gain earnings surprises are negative for 7(9) of the 10 deciles for gain-year firms. The magnitude of the gain is closely aligned with the magnitude of pre-gain earnings surprise in that the largest gains occur when the earnings surprise is most negative. We interpret our findings as evidence that managers manage reported earnings to meet analysts' forecasts.

Finally, in Table 4 we present an analysis of our sample by years. Reported gains from the issuance of subsidiary stock increases both in size and incidence in more recent years. 42 of the 125 observations (34%) have occurred in the last two years, and the mean of 1996-1997 gains (\$64.9 million) exceeds the mean of the other eleven periods (\$33.9 million) by 91%.

We also checked for industry clustering (not shown) and found that no single industry (measured at the 3-digit level) dominates our sample. This suggests that results are not driven by industry.

Table 4
Gains and Earnings Surprises by Year

Year	N	Mean [Median] Gain (Million)	Std. Dev.	Mean [Median] Gain/Share	Std. Dev.	Mean [Median] Earnings Surprise After Gain /EPS	Mean [Median] Earnings Surprise Before Gain/EPS
1985	5	10.20 [6.00]	13.33	0.132 [0.102]	0.139	0.153 [0.000]	-0.009 [-0.111]
1986	7	14.19 [4.70]	24.87	0.155 [0.026]	0.250	-0.107 [-0.002]	-0.309 [-0.159]
1987	11	58.09 [7.35]	105.78	0.258 [0.141]	0.316	-0.186 [-0.008]	-0.466 [-0.215]
1988	7	38.85 [7.89]	64.03	0.272 [0.243]	0.264	-0.247 [-0.058]	-0.472 [-0.279]
1989	3	11.39 [8.70]	4.66	0.184 [0.189]	0.146	0.212 [-0.005]	-0.042 [-0.024]
1990	7	11.81 [15.30]	8.57	0.127 [0.130]	0.072	0.163 [-0.022]	-0.400 [-0.465]
1991	6	15.79 [11.25]	14.06	0.193 [0.066]	0.272	-.0140 [-0.014]	-0.428 [-0.221]
1992	7	66.89 [30.21]	93.56	0.335 [0.222]	0.256	-0.105 [-0.023]	-0.704 [-0.423]
1993	10	14.10 [11.42]	12.29	0.154 [0.098]	0.149	-0.189 [-0.015]	-0.443 [-0.245]
1994	9	66.71 [11.22]	147.85	0.303 [0.174]	0.277	-0.245 [0.000]	-0.649 [-0.284]
1995	11	65.11 [54.15]	68.40	1.068 [0.187]	2.000	-0.017 [0.000]	-0.506 [-0.157]
1996	24	57.64 [13.87]	98.13	0.352 [0.195]	0.410	-0.115 [0.007]	-0.571 [-0.275]
1997	18	72.17 [25.45]	110.78	0.510 [0.254]	0.715	-0.092 [0.015]	-0.525 [-0.296]

Some firms have multiple observations: 23 firms have one observation, 13 firms have 2 observations, 9 firms have 3 observations, 6 firms have 4 observations, 1 firms has 5 observations, 1 firm has 7 observations, and 1 firm has 13 observations. 54 firms make up the total 125 observations.

CONCLUSIONS

Managers can achieve earnings goals through a number of earnings management techniques including accounting estimates, accounting choices, expenditure decisions, corporate combination transactions, working capital decisions, and investment portfolio decisions. The purpose of this study is to explore the issuance of subsidiary stock as part of an earnings management strategy. We argue that having a controlling interest in a subsidiary present the opportunity for managers to affect consolidated net income by encouraging the subsidiary's investment decisions. Initial public offerings of subsidiary stock and secondary offerings by publicly traded subsidiaries can result in gains on the issuance of subsidiary stock on the consolidated income statement. Presumably the parent firm can influence the timing of the offering, and therefore can use the gain from the transaction to achieve earnings management goals. We hypothesize that managers make income-increasing accounting decisions related to reporting gain on the issuance of subsidiary stock when earnings would otherwise be below analysts' forecasts. This paper provides systematic evidence consistent with this prediction. We find that when gains on the issuance of subsidiary stock are reported, they effectively cover otherwise disappointing earnings.

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APPENDIX

EQUIVALENCE OF PROPERLY STRUCTURED SALES OF SUBSIDIARY SHARES TO NONAFFILIATES AND OTHER OWNERSHIP PERCENT DECREASING TRANSACTIONS

If a subsidiary company purchases or sells its own capital stock on a *nonratable* basis between the parent company and third parties (including existing minority shareholders), the parent's percentage ownership will change. The same effect on the parent's ownership interest can be achieved simply by having the parent purchase or sell subsidiary shares in the open market. However, if the infusion of new capital directly into the subsidiary is desired, the nonratable subsidiary transaction may be restructured to include an open-market purchase or sale of subsidiary shares by the parent and a *ratable* issuance of new shares by the subsidiary such that all parties continue to experience the same economic effects as they do in a nonratable purchase or sale by the subsidiary of its own capital stock. By virtue of its control, the parent can choose any of these three alternatives. Therefore, since the alternatives are fundamentally equivalent in terms of economic substance, we support the position that the accounting impacts of subsidiary stock issuances or repurchases should be consistent with the parent's accounting for open-market purchases or sales of its holdings of subsidiary shares.

In the main body of the text, we provided a brief illustration which assumed that the subsidiary issued new shares solely to third parties. Using the data of this illustration, we depict below the economic effects on the parent and subsidiary of choosing the two alternative transaction forms.

Restatement of Basic Facts

Assume that an 80%-owned subsidiary with 1,000 shares of common stock outstanding has net assets (shareholders' equity) of \$250,000 on January 1, 2001. On this date, the subsidiary issues an additional 200 shares of its stock to third parties for \$68,000. As a consequence of this transaction, the parent company's percentage ownership interest in the subsidiary drops from 80% (800/1000 shares) prior to the sale of shares to 66.7% (800/1200) after the sale of shares. At the same time, the increase of \$68,000 in the net assets of the subsidiary increases the parent's equity in these net assets from \$200,000 (80% of \$250,000) to \$212,000 (66.7% of \$318,000), yielding a "gain" of \$12,000. We will assume for convenience that the parent's cost is equal to its equity in the net assets of the subsidiary, or \$200,000.

First Alternative Transaction Form

The reduction of the parent's ownership from 80% to 66.7% could have been accomplished through an open market sale by the parent of 133 shares of the subsidiary. At the assumed market price of \$340 per share, the profit recognized by the parent company would be approximately (due to rounding) \$12,000 [proceeds of \$45,220 (133 x \$340) less an allocated cost of \$33,250 ((133 /800) x \$200,000)]. This gain, which is recognized as income under current GAAP, is the same as the gain generated in the basic nonratable sale of new shares by the subsidiary.

Whether the parent elects to dispose of this ownership interest through an open-market sale of shares of the subsidiary by the parent, or by having the subsidiary issue additional shares of stock to third parties, the case can be made that the accounting for the value received for the interest (whether in cash or an increased interest in the net assets of the subsidiary) should be consistent. There is, however, a difference in the amount of funds provided by outside parties (including the existing minority shareholders) to the economic entity. In the basic set of facts, the subsidiary receives \$68,000 for the 200 new shares. In this first alternative transaction form, the parent receives \$45,220 from third parties for the 133 shares it sold in the open market. If this difference in funds provided fails to establish a sufficient equivalence to argue substance over form, we can consider a two-stage alternative transaction form in which all economic effects are identical.

Second Alternative Transaction Form

To achieve exactly the same effects as are produced in the base case, the transaction is here restructured as a two-stage transaction. First, the subsidiary issues the 200 new shares of stock at \$340 per share *ratably* to the parent and third parties (including existing minority shareholders). This means that the parent purchases 160 shares in this first stage. Second, the parent simultaneously sells in the open market 160 shares from its portfolio of 800 shares at the same \$340 per share price. The final result is the sale of 200 shares of the subsidiary to third parties at \$340 per share, with the total proceeds of \$68,000 going to the subsidiary. There is no change in the cash position of the parent.

The parent is a party to both transactions, and thus must formally recognize each in its books. In the case of the ratable issue of subsidiary stock, the parent will recognize an increase in its investment in the subsidiary of \$54,400 (160 shares x \$340). This cost is exactly equal to the increase in the parent's equity in the net assets of the subsidiary $[(80\% \times \$318,000) - (80\% \times \$250,000)]$, and so there is no unresolved "gain or loss" from a subsidiary stock issuance. [In fact, any ratable subsidiary stock issuance always has this property]. The sale of the 160 subsidiary shares in the open market (the second transaction) yields a profit of \$12,000 [proceeds of \$54,400 (160 x \$340) less an allocated cost of \$42,400 $((160 / 960) \times \$254,400)$]. As noted above in our first transaction alternative, this open market sale of investment shares is recognized as income under current GAAP.

Under this second alternative, we again recognize the same profit on the disposal of the 13.3% interest in the subsidiary. Additionally, the economic effects are the same as in the base case. Under these circumstances, substance over form would seem to support income treatment for the nonratable sale of shares by the subsidiary in the base case.

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The authors wish to thank Dennis Patz, Charles Ransom, James Beard and other participants in the Oklahoma State University School of Accounting Workshop for their helpful comments. They also want to express their appreciation to the McIntire School of Commerce at the University of Virginia for financial support for this project. We gratefully acknowledge IBES International Inc., for providing earnings per share forecast data available through the Institutional Brokers Estimate System.